US Agency for International Development
Study of Innovative Practices in SME Finance

Case Study: Business Partners (South Africa)

Venture Capital & Mixed Financing

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Background

This paper is part of a six-study series that was conducted by the U.S. Agency for International Development (USAID), with assistance from Deloitte Touche Tohmatsu. The purpose of the study series is to identify and document innovative practices in SME financing. The information for this study was obtained from on-site visits and interviews with management of each of the organizations. The interviews were conducted by Suzanne Nolte Saunders of USAID's Economic Growth, Agriculture and Trade Bureau, Office of Economic Growth, with assistance from Teresa Mastrangelo of Deloitte Touche Tohmatsu for the Uganda and South Africa cases and from Maribeth Murphy of Deloitte Touche Tohmatsu for the Chile case. For more information on the overall series or to find the other study documents, please go to *http://www.usaid.gov/economic_growth/egat/eg/tech-financial*

Acknowledgements

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List of Selected Interviews:

- Hans Falkena, Consultant, South Africa Reserve Bank
- Thomas C. Gibson, President, Institute for SME Finance
- Jo’ Schwenke, Managing Director, Business Partners

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I. Introduction

Business Partners (Partners) is an investment company in South Africa that targets small and medium enterprises (SMEs) and operates under the non-executive Chairmanship of Mr. Johann Rupert and is managed by Jo' Schwenke, who has served as Managing Director since 1996. Partners strives to combine development with profit, seeing them as compatible goals. How Partners intends to achieve both development and profit results is reflected in its vision:

> To be a world class added value investor in small and medium enterprises thereby facilitating the creation of jobs and wealth in South Africa.

The ways that Partners invests capital, skill, and knowledge into SMEs are what make this organization unique in terms of SME financing.[1] Partners shares the credit risk with its customers through the use of flexible equity based investment products. Partners also manages the risk associated with working with SMEs by doing thorough financial and management due diligence at the front end of the deal and, once the investment has been made, by arranging for and subsidizing the cost of expert mentors for the SMEs on an ongoing basis. Through this process, Business Partners not only ends up financing good clients, but the Partners team also brings substantial consultative value to their clients. At the same time, Business Partners has aligned itself with the interest of the client and will make concerted efforts to ensure the client's business grows.

This case study on Business Partners will explore how the company structures its financing and customer relationships to promote SME growth while growing Partners' profits. The study will start by looking at the context in which Partners is operating and the evolution of the company, and then will examine in more detail Partners' target market segments, terms and types of financing, process for reviewing and approving investments, types of business consulting and mentoring, approaches for exiting, and staff management. Following these specifics will be a discussion on how USAID missions and other donors might incorporate aspects from this case into their program designs.

Unlike the other cases in this series, this study did not include client interviews due to travel and scheduling conflicts. As a result, it does not benefit from any client feedback. In addition, Partners is actively involved in property investments. However, this case does not cover the property investment activities; more information can be found about these on Business Partner's web site, http://www.businesspartners.co.za.

II. South Africa Environment

South Africa is among the largest 25 economies of the world. With a 2000 GDP of \$125.9 billion,[2] its economy is about the size of that of Sweden or Switzerland[3] and,

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[1] SMEs are defined by Business Partners based upon deal size. They only serve enterprises financing requirements of \$15,000 or more.

[2] 1 USD = 10.5358 ZAR

[3] Sources, EIU Country Profile 2001 and World Bank, http://www.worldbank.org/data/

according to World Bank statistics, is about 30 percent of the GDP of all of Africa. Its banking sector is fundamentally sound, with a complete range of financial instruments available. The South African formal banking sector is dominated by nine registered banks whose outstanding loan portfolio account for 58 percent of the outstanding loans in the country. The table below provides further statistics on South Africa's banking sector.

Table 1: South African Banking Sector Overview

South African Banking Sector	# Registered Entities	# of Branches
Banks	9	342
Public Companies	9	326
Private Companies	171	2,521
Close Corporations	838	14,867
Trusts	76	129
Co-Operatives	1	1
Section 21 Companies	17	49

Source: Dow Jones, 2002

Within the nine registered banks there exist the "Big Six" banks: Standard Bank, Nedcor, First Rand, ABSA, BOE and Investec. According to the 1999 South African Banking Review, the combined assets of the Big Six accounted for some 88 percent of the market.

III. Serving the SME Sector

The South African business community is heavily populated with small and medium enterprises. While the country has a population of approximately 45 million people (World Bank, year 2000 numbers), the labor force, defined by Statistics South Africa as economically active individuals in the formal and informal sectors, is only approximately 15.5 million people (1998 estimate). Business Partners estimates that there exist some 600,000 SME businesses in the country.

Typically, though, the major banks have focused on lending to large, established businesses, and affluent individuals. Some small and medium enterprises have received funding as well, provided they demonstrate creditworthiness. The 1999 South African Banking Review captured the theme well:

> The financing of 'medium' and 'small' businesses is profitable business for banks, and established creditworthy medium and small enterprises do not usually have difficulty in obtaining bank finance (although start-up businesses might). But the cost of making loans to start-up micro enterprises, which are inadequately capitalised and have few managerial

> skills, is enormous compared to the amount of the loan. It is almost impossible for micro-entrepreneurs to cover those costs. Lending to 'very small' start-up enterprises is not much different.

Unfortunately, in most cases the small and medium enterprises with demonstrated credit worthiness are owned and operated by the advantaged classes, and lending to these types of enterprises does little to expand the credit base to formerly disadvantaged citizens. Under apartheid, blacks were effectively banned from owning legitimate businesses, which deprived them of relationships with the formal banking sector and thereby prevented them from both developing credit histories and from gaining the understanding of how to properly manage a business. Therefore, black entrepreneurs, or "formerly disadvantaged" entrepreneurs have faced an uphill battle when it comes to receiving financing for their business ventures.

One of the goals of the current South African government is to increase the "empowerment" of the formerly disadvantaged population (disadvantaged is usually defined as black and white women, black is defined as black, Indian, and colored origin). Empowerment entails an improvement of political, social and economic well being, and improving the lot of the disadvantaged entrepreneur through increased access to business credit and financing is a fundamental step towards that goal. The government, in order to promote empowerment, has put considerable pressure on the formal banking sector to increase its lending to formerly disadvantaged businesses and microentrepreneurs. Consequently, many banks have introduced micro-loans and hundreds of microfinance institutions, NGOs, and the like have begun operating in South Africa.

Regulatory Environment

The current structure determines the authority of several regulators (SARB, FSB, MFRC, DTI) over financial activities based on whether they fit within the Banks Act, Mutual Banks Act, Usury Act, Credit Agreements Act, or one of the Exemption Notices. This raises concerns about the incentives provided to the financial institutions to lend to the SME sector, as well as the capacity of the regulators. A number of legal and regulatory reforms have been proposed to ensure appropriate governance of the small enterprise lending market.

There still remains a "missing middle" between standard bank lending and micro-credit. A proposed amendment to the 1990 Banks Act[4] will require South Africa's banking sector to disclose, for the first time, the details of their lending to the lower end of the market. This new regulation will also forbid banks from refusing loans to borrowers simply because they come from high-risk areas or segments of the population. This regulation comes amidst strong government pressure for the commercial banks to begin looking at ways to down-market their business. Furthermore, there is growing awareness among the main South African banking groups that they must change their expansion

[4] Available at:
http://www.reservebank.co.za/internet/Publication.nsf/LADV/0A5908EA3136436342256BE4002215C6/$File/BANKS+ACT+AMENDMENT+BILL2.pdf

strategies before they run out of options in the domestic market. This means that the banks recognize that they will run out of road in their domestic market if they do not tap new earnings streams outside of their traditional franchises.

While the commercial banks have been under pressure (both economically and politically) for some time to address the needs of the previously disadvantaged sectors of the population and economy, they are ill inclined to pursue microfinance activities since a major micro-finance crisis began afflicting the financial sector in February 2002. A R1bn run on the deposits of a major micro-lender, followed by major losses in the micro-lending arms of major banks (such as ABSA, one of the Big 4 South African banks) is turning the banking sector away from micro-lending. However, government pressure to deliver improved living standards and empowerment to the majority of the population is intense, and banks have begun looking at more creative down-market options, which could bode well for the South African SME sector.

ABSA, in addition to Standard Bank and First National Bank, have accordingly, begun new programs targeted toward “emerging” businesses. These in fact are SME lending programs targeted at the black business owner, instead of their traditional white SME borrower. In this way, meeting the financing needs of SMEs for development purposes requires unique solutions which take into account South Africa’s mixed economy, characterized by several bankers as “first world” and “third world.”

Credit and Market Research Information

On top of the increasing focus on the SME sector, South Africa has already built some of the fundamental infrastructure elements necessary for successful SME financing. South Africa is one country where credit information is available, putting it miles ahead of many other countries in which USAID and other donors operate. In South Africa, there are at least two Credit Bureaus which provide good information on corporate and private borrowers, and certain banks and financial institutions have gathered additional information. However, for much of the population engaged in informal sector activities (comprised largely of black South Africans – 78 percent of the population), credit histories are short or nonexistent, as a result of apartheid prohibiting them from owning legitimate businesses. This situation (lack of information on informal sector borrowers) has led some of the specialized financial institutions serving the informal sectors to develop private records on their borrowers.

Sophisticated market research is also available in the South African market, but it often does not provide sufficient data on the SME sector for conduct of feasibility studies. Accordingly, to support their own due diligence process, Business Partners has assembled a database about customers’ businesses to complement the information already available from the credit bureaus, which Partners uses to make credit decisions. This sort of market information is especially important in the type of financing to small and medium enterprises which will rely on projected cash flows to determine the attractiveness of the borrower’s project. The database allows Partners to compare profiles of types of businesses to determine common characteristics, including for example, typical financial ratios.

IV. Business Partners Background

Business Partner's predecessor, Small Business Development Corporation (SBDC) was registered as a public company in 1981 under the leadership of Dr. Anton Rupert to stimulate small business entrepreneurship of all South Africans. Its authorized share capital was ZAR 150 million, which was held 50/50 by the State and private sector. Its initial Board of Directors included 27 members of the private sector and seven members nominated by the State.

The company initially concentrated on two main functions: financial assistance to economically viable businesses and the provision of commercial buildings for SME tenants. Later, it expanded its services to the SME sector by instituting a credit guarantee scheme in conjunction with various banks, by introducing business consulting services, and by being an influential force in the removal of statutory and administrative obstacles at the provincial and local government level.

The South African government gave SBDC ZAR 60 million per year from 1986 to 1993 to finance development programs. In 1994, the government did not provide the ZAR 60 million. The SBDC, which had been relying on a high volume of transactions with low profit margins, had to reconsider its business approach and survival strategy now that the government funding was gone. At that time, a big portion of the portfolio was non-performing and earnings per share were significantly lower than today. The management decided to revise the business approach based on the hypothesis that if all high-risk customers had proper capital structures, even though they may make lower returns, they would be more sustainable and better performing customers.

The result was that in 1996, the State reduced its shareholding in the company from 50 percent to 20 percent through receiving a payment from the SBDC of ZAR 600 million. Four years later, in 1998, SBDC changed its name to Business Partners Limited to emphasize the partner relationship with clients, reflect the majority private ownership, and more accurately identify itself with the SME sector rather than with informal enterprises.

The government used the proceeds from the restructuring to create Khula, the development finance company that was created by the Department of Trade and Industry to allow easy access of loans and development finance to small, medium and micro enterprises (SMMEs).

V. Business Partners Overview

The company has four investment funds, a venture capital fund, a property management division and a mentorship division. Partners' focus is on enterprises requiring between R150,000 and R15million ($15,000-$1.5 million as of June 2002). The investment funds will be used for investments at all stages of a company's development in the commercial, manufacturing and service sectors of the economy, with the exception of on-lending activities, farming operations and non-profit organizations. The venture capital fund is used for higher value and higher risk private equity and venture capital investments, targeting well managed, innovative entrepreneurial SMEs with high growth potential. This latter fund will be used in cases of management buyouts, management buy-ins, expansion, acquisition, and start-ups, but are not eligible for use as seed capital. See the below figures on the investment portfolio:

Table 2: Fund Details for Investment and Venture Capital Funds

	Central Fund	East Fund	South Fund	West Fund	Business Partners Ventures
Fund Size (ZAR MM)	310	324	290	300	100
Funds Invested to date at Cost (ZAR MM)	268	32	220	221	34
Current Portfolio Size (ZAR MM)	887	808	616	915	8
Average current investment size (ZAR)	1.1MM	550,000	700,000	409,000	3.1MM
Total number of private equity investments made	120	127	76	60	8
Number of Investment Executives	20	25	16	21	6

Source: SA Venture Capital and Private Equity Association

Table 3: 2001 Approved Investments by Sector

Professional and Personal Services	26%
Manufacturing	17%
Retailing	14%
Restaurants, Fast Foods and Pubs	10%
Motor Trade	9%
Guesthouses, Hotels and Caravan Parks	8%
Horticulture, Quarrying, Wholesaling and Communication	8%
Coastal Fishing	7%
Building, Plumbing and Shopfitting	2%

Source: Business Partners

Partners sees as its competitors:

- Private equity investment firms
- Large commercial banks

- Industrial Development Corporation of South Africa, LTD (IDC)—a self-financing state-owned development finance institution
- Some of the South African provincial funds, in particular, the Ithala fund from Kwazulu-Natal province, which is strong in investments in empowerment projects.

Some of this competition is more recent due to IDC moving down-market to smaller transactions in sectors such as manufacturing, tourism and empowerment, and some of the bigger banks starting to take equity positions in client businesses. South Africa does not currently have a strong venture capital industry so there is limited competition from venture firms.

Some highlights of Partners' performance include:

- During fiscal year 2001, Partners approved 766 projects at a total cost of ZAR 578.5 million, reflecting significant growth from 1982 when they financed 188 projects with ZAR 11.2 million
- Partners' investment goal for fiscal year 2002 is ZAR 700 million (about $ 6.8MM as of July 2002)
- Since the company's inception in 1981, Partners has invested ZAR 4.6 billion into SMEs businesses, enabling the creation or maintenance of nearly 500,000 new jobs. The company's current investment portfolio stands at ZAR 1.1 billion
- Partners' shareholder value has increased by more than ZAR 1 billion over the past two decades

VI. Target Businesses and Segments

Business Partners segments the SME market that it is focused on into two types of business categories:

1. <u>"Lifestyle" businesses:</u> Businesses with the potential to provide the entrepreneur with a comfortable lifestyle, such as filling stations, franchises, supermarkets and spas.

2. <u>"Blue Sky" businesses</u>: Innovative businesses with high growth and profit potential – these can cut across all industries depending on the individual business concepts.

Most of Partners' investments and value adding services are concentrated in the "Lifestyle" business sector. Only 20 percent of the investments are startups or buy-outs by a new entrepreneur from previous owners; otherwise all others have ongoing businesses.

In addition to the size, type and industry, Partners also pays attention to the race and gender of the owners. In 2002, 30 percent of the deals were with women and 30 percent with blacks. The company's targets for its 2003 deals are for 32.5 percent of entrepreneurs to be women and 40 percent black, as measured by the higher of the deal value or volume. Partners' commitment to supporting women is evidenced by the following news clip:

> 'Women demonstrate a rare combination of attributes,' says Tersia van der Merwe [General Manager: SystemsControl at the company and also the National Treasurer of the Businesswomen's Association]. 'Not only do they have vision, ambition, financial discipline and staying power, they also have excellent insight into the needs of their target markets and the people skills to deliver world-class products and services.'
>
> 'As far as women in business are concerned, we have a blue sky vision,' concludes van der Merwe. 'We want to enable more and more women to take up meaningful roles in the business community and, by so doing, to create wealth for themselves, to facilitate the creation of new jobs and to contribute in a real way to the growth of the South African economy.'[5]

VII. Customer Sourcing

Partners actively "hunts" for good clients, relying heavily on professional firms such as accountants and lawyers for identifying candidates. To assist in this process, Partners has developed a Sourcing Database that has contact information for hundreds of intermediaries. Partners considers that, in general, the clients they find through references and other targeting have better business prospects and are lower risk clients than the ones who seek them out.

VIII. Terms and Types of Financing

Partners offers various financing products depending on the profile of the client. Although a small portion of loans are standard bank-like loans that require 100 percent collateral and good credit history, Partners' general approach is to share in the risk and rewards of private investment through holding shares with the entrepreneur/proprietor in client firms and receiving dividends (royalties) and capital appreciation. Partners structures their investment capital by way of equity, quasi-equity and term debt. The royalty Partners charges is based on sales or free cash flow, and in cases where equity ownership makes sense, Partners takes minority ownership and the entrepreneur takes the rest. After the shareholders' loans have been repaid in full, the entrepreneur has a right of first refusal should Business Partners wish to sell its shares at market value. See the below table for a summary of Partners' approach.

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[5] Business Partners website, accessed July 15, 2002.

Table 4: Business Partners' Terms and Types of Financing

Investment Targets	• Target Deal range: ZAR 150,000 to ZAR 15 MM (about $15,000 to $1.5MM). Partners prefers not to do deals less than ZAR 500,000 due to interest rate ceilings on loans of that size imposed by the South Africa Usury Act[6] • Average IRR for investments other than straight loans is 25%.
Loan Terms	• Term loans are extended for 4-6 years at variable rates. • Interest rates are normally at the prime rate, with the risk on the interest rate offset by royalties and equity appreciation.
Client Attributes	• Partners looks for clients that, first and foremost, are honest, possess "doing" skills, business skills, and demonstrate entrepreneurial/risk taking qualities. Accordingly, they often refer to a client as "the entrepreneur" when describing their business relationship
Equity Stake	• When Partners takes an equity position, they usually take 25-45 percent of share capital and the client holds the remaining majority. Typical sharing of equity is 70 percent share to entrepreneur, 30 percent to Partners. • Partners has an outstanding put for the duration of the loan and must give the buyer the first right of refusal. In contrast, the buyer does not have a call and cannot dictate the timing of the share repurchase. • For indemnity and equity transfer purposes, the entrepreneur forms a new company with the funds from Partners.
Royalties	• Business Partners collects royalties as a percentage of revenues or free cash flow. The royalty percentage is usually included in the financing contract at the higher of planned or actual. Its term is determined separately from the loan.
Security	• The client pledges whatever collateral is available, which usually is no more than 60% of loans.
"Aftercare"	• Partners can include in the terms of the investment the required use of a mentor for which the cost is borne by the client. The mentor can be used to enhance business results, or, in dire situations, to try to turn around the client business.
Exit	• Terms and related formulas are included in initial contract. • Long-term cash flow projection to determine best share repurchase schedule which ensures client can afford required cash outlays. • Actual valuation of ownership stake is negotiated using contract terms, but somewhat subjective due to expected future prospects.

Business Partner's investment transactions are customized to the nature and growth prospects of their clients. Some loose groupings of clients are listed below:

[6] In interviews and in recent literature, we found that South Africa's Usury Law is believed to be the single biggest regulatory constraint to allowing SME access to credit. See J. Patrick Meagher and Betty Wilkinson, *Filling The Gap In South Africa's Small And Micro Credit Market: An Analysis Of Major Policy, Legal And Regulatory Issues. IRIS Discussion Papers On Institutions & Development*, Paper No. 02/01, August, 2002.

1. Loan Partner

- Well established businesses
- Lending is very similar to bank lending, backed by 100 percent collateral
- Loan product is not a particularly profitable product.

2. Incentive Partner

- Smaller high risk ventures
- Cost of converting to a new company or equity participation is not practical or justified

Partners Financing:

- Extend a term loan to finance business expansion
- Collect a royalty that is a percentage of revenues or free cash flow and is contractually fixed at the higher of planned or actual cash flows. The royalty, or as Partners terms it, incentive fee, is taken to balance the risk of the uncovered portion of the loan.
- Determine term of royalty payment relative to the loan term, as the royalty term can either be shorter or longer than the loan term

3. Risk Partner

- Limited own capital
- Limited security/collateral
- Viable lifestyle business able to generate sufficient cash flow to afford the regular repayments of a loan

Partners Financing:

- Take a minority stake in the company of up to 45 percent.
- Extend a term loan to finance business expansion at or near prime rate.
- Take liens to the maximum extent possible, which may cover up to 60 percent of Partners' investment.
- Collect a royalty that is calculated up front as a percentage of revenues or free cash flow and that is contractually fixed at the higher of planned or actual.
- Determine term of royalty payment relative to the loan term, as the royalty term can either be shorter or longer than the loan term.
- Develop formula for calculating value of equity over the term of financing and include formula in contract.
- Depending on the expected level of free cash flow and expected ability of client to be able to buy Partners' equity stake, determine a share repurchase schedule that uses any free cash after operating expenses, royalties, interest and principle payments for repurchasing shares during the term of the loan rather than at the end. For example on a six-year loan, the client may start to buy back shares at year three.

4. Equity Partner

- Very profitable venture

- Solid capital base
- Needs expansion capital

Partners Financing:

- Client creates a new company and sells old company into new company
- Partners takes a minority stake in the new company and extends a combination of a term loan and a shareholders loan, the latter having the characteristics of equity depending on the stipulations in the tax law and other aspects of the investment.
- Partners develops a formula for calculating value of equity over the term of financing and includes the formula in the contract.
- Partners determines a share repurchase schedule that uses any free cash after operating expenses, royalties, interest and principal payments for repurchasing shares during the term of the loan rather than at the end. For example, on a six-year loan, the client may start to buy back shares at year three.

5. Private Equity/Venture Partner

- Well managed, innovative and entrepreneurial
- High growth potential – primarily suitable for "Blue Sky" investments

Partners Financing:

- Similar to that of Equity Partner (#4 above) but with a more substantial investment of up to ZAR 15 million.

Partners' use of flexible financing addresses the potential problem of business mismanagement, some of the exit problems, as well as reduces the costs of 100 percent bank loan financing. Rather than requiring that a business's financial flows to fit to the financing instrument, Partners fits the financing instrument to the business. For example, with 100 percent financing of a business expansion with a loan, the loan servicing may be too excessive to be affordable. Partial equity financing causes loan-servicing costs to drop and allows a longer period for the business to ramp up and increase sales. At the same time, stock repurchase payments that are incorporated into the term of the deal take account of the time the business needs to ramp up, how much free cash flow there will be, and how the entrepreneur can afford the payments after the debt servicing and any royalties.

Business Partners structures their "deals" and undertakes rigorous IRR analysis to ensure that the realized interest rate adequately compensates them for the risks. There are no players in the market able to provide financing to SMEs at the average rate of 25 percent.

IX. Reviewing and Approving Investments

As of 1996, Partners started following a more aggressive process to analyze deals for maximum returns and creatively structure them to minimize risk. Their deal process takes four weeks on average, depending on complexity of financing terms and ease of getting information on the client. The steps during the review and approval period process include:

1. Receive request from business and get their business plan
2. Determine whether the business idea is sound and whether financing from Partners is possible
3. Tell the applicant whether financing looks possible or not possible within a week of receiving their business plan. For clients that Partners turns way, Partners often recommends alternative sources of financing
4. For potential clients, agree on a timetable for due diligence and Partners' final decision
5. Write due diligence report (Partners portfolio manager). Portfolio managers are usually working on six or seven of these reports simultaneously. They include:
   - A thorough review of a company's financials
   - A revised business plan developed by the portfolio manager, which reflects his or her revised cash flow actuals and projections
   - Results from discussions with potential client's customers
   - Results from other types of verification of the potential client's business transactions, such as of leases and buy-sell agreements
6. Develop financing terms similar to one of the client groups above
7. Restructure/amend client's business plan with new loan terms and conduct an Internal Rate of Return (IRR) analysis to ensure investment exceeds the hurdle rate
8. Develop a contract that specifies all requirements for financing, including details around the creation of a new legal company, current and planned transfers of ownership, loan and royalty payment terms, and any additional risk minimizing provisions such as requiring the clients to purchase forward contracts to cover cost of imports

X. Client Assistance and Mentoring

In addition to the value that Partners brings its clients through business plan consulting and the development of accurate projections, Partners finds and subsidizes highly skilled mentors to work with the entrepreneurs on an ongoing basis. Partners has developed a database of over 200 experts who are available to be mentors and whose names are organized by Standard Industrial Classification (SIC) Codes. They are often retired executives with a variety of expertise, such financial management, production, inventory management, process management, systems, etc. Partners subsidizes the cost of the mentoring program, but requires that the entrepreneur pay for the mentor. On average, the total cost for the mentor to the entrepreneur is about R 1,000 per day. Of that, approximately R 750 goes to the mentor as compensation and the remainder to Partners to cover overhead costs. Highly specialized mentors, for example, in production processes, may cost R 5,000 per day.

Partners can use mentors from the inception of the financing arrangement or can bring them into companies that are having trouble and try to turn them around. Under the turn-around scenario Partners may cover the entire cost of the mentor to salvage the business and their investment.

XI. Exit

One of the key elements of Partners' approach to their investments is that they develop the terms for recouping their investment at the inception of the deal. One of the well-known problems attached to private equity and venture capital investing in developing countries is the difficulty in exiting the investment. Plans for initial public offerings (IPOs) of the company's shares are often abandoned due to insufficiently developed capital markets. Or, for scenarios depending on eventual management buy-outs, poor business and cash management practices can render the entrepreneur unable to make the large cash outlay at the end of the investment term. This latter scenario is particularly applicable for the majority of Partners' customers since one of the definitions of a "lifestyle" business is that the entrepreneur uses any excess cash to manage the family's affairs, and is not as likely to save it for business expansion or reinvestment.

As discussed, Partners either schedules share repurchase payments into the payment period, such as in the latter few years, or it predicts that either the current management, new management or other companies will be likely purchasers for the shares. As far as the valuation of the equity stake, the availability around these details is limited. Although formulas for valuation are included in the financing contract, it seems to come down to negotiation between Partners and the client. No feedback was obtained from clients on this process so it is difficult to ascertain the fairness of these transactions.

XII. Staff Training and Management

Business Partners consists of two businesses, Property Management with 100 people and Business Finance with 280 people, which includes about 55 people in each of four regional funds. There are six people in management at Partners' headquarters who develop the overall strategy and related policies. Most other functions are performed at the individual funds. The staff composition as of June 27, 2002 was, of 387 total, 158 female and 229 male, 188 black and 199 white. The levels of staff are:

- Portfolio manager (equiv. to loan officer)
- Area manager
- Fund manager
- Management/Board

The staff incentive system includes multiple ways of remunerating Partners staff, including bonuses and carried interest based on deal returns.

Partners' staffing strategy is to hire graduates with two or more years of experience. They also use a trainee scheme in which they hire university graduates as interns for one year and then, based on the performance and interest, hire them full-time. From this internship program, Partners hires about 40 percent after the year, loses 40 percent to better offers, and terminates the remaining 20 percent.

XIII. Future Plans

Generally, it appears that in South Africa, government and donor credit enhancement and credit guarantee schemes are riddled with problems and are becoming politically unacceptable. Accordingly, the demands for SME finance will have to be met by the private sector.

Business Partners is well ahead of other potential financing sources in the market, particularly the large commercial banks, in meeting the needs of new entrants in this sector. For the year 2002, it plans to expand its client base, targeting at least 40 percent of new clients as black clients and 32 percent of new clients as women. In 2001, 30 percent of Partners' deals were conducted women and 30 percent with black entrepreneurs. For the future, Partners expects the expansion of the SME sector in South Africa to be great, as a result of liberalization of the economy and black empowerment. In addition, a change or repeal of the Usury Act is likely to bring more players into the market. However, the banks are currently building their "emerging businesses" units and, if they are able to build the expertise and products needed to overcome the current constraints they face in lending to non-traditional SMEs, competition will increase. Nevertheless, it is unlikely that more than 10 percent of the large bank's loan portfolios will be for loans to SMEs.

Business Partners continues to diversify its products for the SME sector. Partners recently bid on management of two government funds: one at ZAR 30 million, the other at ZAR 100 million. In their proposals, Partners has asked that it also be allowed to manage those funds directly, in order that it may generate interest and use the additional funds for technical assistance (mentoring). If awarded the mandate to manage these funds, Partners would have the capability to target riskier clients. Partners plans to target franchises under these planned programs and would add area managers to each fund of their four funds to manage these amounts. According to Mr. Schwenke, mentorship would fill the "gap between where this person is and where they need to be." They propose that the new entrepreneur use Partners' mentors on a success only basis. That is, the entrepreneur would only pay back the technical assistance costs if his or her business is successful.

XIV. Conclusion

Business Partners is currently an entirely private sector entity. Much of its success is due to the vision of its past and current management. However, there are some lessons learned which donors and/or private sector lending could consider in designing similar SME programs. First, Partners' methodology and use of risk partner, incentive partner, and equity partner products are meant to overcome some of the structural barriers faced by traditional lenders which limit the supply of SME finance.

One barrier overcome by offering a mix of loan and equity products is the regulatory constraint on the interest rates. In South Africa, the Usury Act limits interest rates well below the rate at which, according to interviews, commercial banks are willing to lend to SMEs.

By collecting fees, in addition to interest, Business Partners is able to be profitable despite the expensive lending methods that must be used for the SME sector. As stated above, Business Partners seeks to structure its products so that there is a reduced loan servicing burden on the SME. This, in part, alleviates the high level of transaction costs for SME borrowers. Furthermore, because Partners specializes in the SME business, it has more information on its clients and more experience with the sector, which should reduce transaction costs and certainly reduces the negative perceptions of the sector, which seems to be a major impediment for South Africa's commercial banks.

As noted above, Business Partners also "insures" its investment through the use of mentors. Because the cost of mentors is borne by the business, there is value attached to their participation by the entrepreneur. This further reduces transaction costs by minimizing the costs of monitoring the investment, particularly as it is routine for mentors to be used to set up a financial reporting system which meets Partners' and other investors' requirements.

We recommend that when designing SME finance projects, an assessment of the financial sector be conducted, focusing on the obstacles to SME finance. Based upon the assessment, donors or lenders may find there is a need for creation of new financial instruments or institutions to increase access to finance by SMEs. If so, we would recommend that readers consider three lessons learned from the case of Business Partners:

1) Financial institutions/financing organizations could use more flexible instruments that include equity components. A donor program based on the Partners' model should include working with the private sector to assist them in designing innovative instruments that are appropriate to the country's legal and regulatory environment and financial sector conditions.

2) Donors should encourage the use of experts who provide mentoring to small and medium businesses. A future project could provide co-financing for their cost. The authors endorse a project design which includes the development of a databank of mentors by working with a local chamber of commerce or similar organizations that are widely available to SME lenders.

3) Privatization, which compels state agencies to compete for customers, may promote innovation and the development of bank and non-bank financial institutions dedicated to serving the SME sector. Donors and/or governments

should consider supporting such transitions by funding market research studies that help the organization better understand its potential customers or by sharing success stories of organizations that have become more customer-based rather than supply-based, as has been exemplified by Business Partners.

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